

2000

Annual report 2000

American Institute of Certified Public Accountants. SEC Practice Section. Public Oversight Board

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PUBLIC
OVERSIGHT
BOARD

Annual
Report
2000

2000

Members of the Public Oversight Board

CHARLES A. BOWSHER

Chairman, 1999 – present; joined Board in 1997; Comptroller General of the United States and head of the General Accounting Office, 1981-1996; Partner of Arthur Andersen & Co., 1971-1981; Assistant Secretary of the Navy-Financial Management, 1967-1971; presently a director of several public companies

DONALD J. KIRK

Vice Chairman, 1999 – present; joined Board in 1995; Financial Accounting Standards Board, member 1973-1977, Chairman 1978-1986; Partner of Price Waterhouse & Co., 1967-1973; Columbia Business School, Professor 1987-1994, Executive-in-Residence, 1995-2000; presently a director of several public companies

NORMAN R. AUGUSTINE

Joined Board in 2000; Chairman of the Executive Committee, Lockheed Martin Corp. since 1997; Chairman and CEO, 1996-97; President, 1995-96; Chairman and CEO, Martin Marietta Corp., 1987-95; Lecturer, Princeton University, 1997-99; Assistant Secretary of the Army, 1973-75, and Under Secretary, 1975-77; presently a director of several public companies

MELVIN R. LAIRD

Joined Board in 1984 and served as Vice Chairman from 1997-1999; Counselor to the President, 1973-1974; Secretary of Defense, 1969-1973; nine-term U.S. Congressman, 1953-1969; Senior Counselor for National and International Affairs, The Readers Digest Association, Inc.; presently a director of several public companies

AULANA L. PETERS

Joined Board in 2001; Retired Partner in law firm of Gibson, Dunn & Crutcher LLP; Member of the POB's Panel on Audit Effectiveness, 1999-2000; Served as Commissioner of the Securities and Exchange Commission, 1984-1988; presently a director of several public companies

ROBERT F. FROEHLKE

Retired from the Board on July 27, 2000; joined Board in 1987; President and CEO of IDS Mutual Fund Group, 1987-1993; Chairman of the Board of Equitable Life Assurance Society, 1982-1987; Secretary of the Army, 1971-1973

PAUL H. O'NEILL

Resigned December 31, 2000 to become the U.S. Secretary of the Treasury; joined Board in 2000; Chair and CEO of ALCOA, 1987-2000; President of International Paper Company, 1977-1987; Deputy Director of U.S. Office of Management and Budget, 1974-1977

The Board is pleased to recognize that A. A. Sommer, Jr., former Chairman of the Public Oversight Board, was awarded the AICPA's Medal of Honor for his distinguished service to the accounting profession at the AICPA's Council Meeting on May 23, 2000.

STAFF

JERRY D. SULLIVAN
Executive Director

CHARLES J. EVERS
Technical Director

JOHN F. CULLEN
Assistant Technical Director

ALAN H. FELDMAN
Assistant Technical Director

LEGAL COUNSEL

ALAN B. LEVENSON
Fulbright & Jaworski LLP

About the Public Oversight Board and the SEC Practice Section

The Public Oversight Board (POB)

An independent private sector body, the Public Oversight Board was created in 1977 for the purpose of overseeing and reporting on the self-regulatory programs of the SEC Practice Section of the American Institute of Certified Public Accountants. The POB is responsible for monitoring and commenting on matters that affect public confidence in the integrity of the audit process. Funded by dues paid by SECPS members, the Board's independence is assured by its power to set its own budget, establish its own operating procedures, and appoint its own members, chairperson, and staff. The Board consists of five members with a broad spectrum of business, professional, regulatory, and legislative experience. Starting in 2001, pursuant to the new Charter, the POB's funding was substantially increased to \$5.2 million to cover its expanded oversight responsibilities. If necessary, additional funds may be authorized should the need arise. The Charter further provides that the POB will select its members from a slate proposed by a new nominating committee.

SEC Practice Section (SECPS)

The SEC Practice Section was founded in 1977 as part of the Division for CPA Firms of the AICPA and is overseen by the Public Oversight Board. The Section imposes membership requirements and administers two major programs to help insure that SEC registrants are audited by member firms with effective quality control systems. The first is peer review, a process to assess the quality control systems and test compliance with them for the accounting and auditing practices of Section members every three years by other accountants. The other is quality control inquiry, which reviews allegations of audit failure contained in litigation filed against member firms involving SEC clients.

Membership in the SECPS

About 1,300 firms belong to the SECPS which audit some 17,000 public companies that file reports with the SEC, including virtually all accounting firms that audit publicly held companies. The requirements of the SECPS affect more than 128,000 professionals at member firms.

Member firms of the SECPS must adhere to quality control standards established by the AICPA; have a peer review every three years, the results of which are maintained in a public file; and report to the SECPS Quality Control Inquiry Committee litigation against the firm that alleges deficiencies in the audit of a SEC client or regulated financial institution. Among other membership requirements, firms must periodically rotate the partner in charge of each SEC audit engagement and conduct a concurring or second partner, preissuance review of each SEC audit engagement.

THE PANEL ON AUDIT EFFECTIVENESS
REPORT AND RECOMMENDATIONS
AUGUST 31, 2000



Chairman's Letter

An exciting new chapter in the history of the Public Oversight Board began in the past year.

Not since the formation of the SEC Practice Section and the POB in 1977 has there been so much focus on the accounting profession's audits of public companies, independence requirements for accounting firms, and self-regulation of the profession. One outgrowth of the year's events has been the broadening of the POB's authority through the adoption by the POB of a Charter in February 2001. Since its formation, the POB had been operating pursuant to By-laws and organizational documents, but without a Charter. The Charter confers new and broader authority.

Among other provisions, the Charter gives the POB oversight responsibilities for the Auditing Standards Board (ASB), which sets audit standards for the profession. The Charter also contains provisions that substantially increase the POB's staff and budgetary resources and further expand its oversight responsibility to include the Independence Standards Board (ISB), which sets standards with respect to independence requirements for firms that audit financial statements of public companies.

But the new Charter is only one of many significant devel-

opments affecting the POB over the past year, including:

- The issuance on September 6, 2000, of the Report and Recommendations of the Panel on Audit Effectiveness. The Panel was appointed by the POB in October 1998 at the request of the then SEC Chairman to review and evaluate how independent audits of the financial statements of public companies are performed and to assess whether recent trends in audit practices serve the public interest. While the Panel made over 200 recommendations for improvements in the conduct of audits and the governance of the profession, and called for the POB to monitor their implementation, the report also found that "both the profession and the quality of its audits are fundamentally sound."
 - The issuance by the SEC of comprehensive revisions to the rules on auditor independence. These rules were adopted after numerous letters of comments and public hearings. The rules identify nine non-audit services, including information technology and internal audit, that, if provided to an audit client, could, depending upon the circumstances, raise issues with respect to an auditor's independence. The rules also modernize the requirements for independence with respect to certain investments and
- employment relationships between auditors or their family members and audit clients. In addition, the rules require proxy statement disclosure of certain information related to, among other things, separate amounts of fees for audit and non-audit services and whether the audit committee considered the compatibility of those services with auditor independence.
- The agreement in June 2000 by the "Big 5" accounting firms and the SEC for the firms to report on their compliance with certain independence rules. Subsequently, the next three largest accounting firms agreed to participate in this program. In addition, this agreement provides that the POB undertake certain oversight of the firms' independence quality controls. This would include review and oversight of the effectiveness of the design and implementation of these controls and testing of their effectiveness. The POB will issue public reports in connection with this oversight.
 - The implementation of "continuous" peer reviews of the largest accounting firms that audit public companies' financial statements that will be pilot tested in 2001. Under this pilot plan approved by the SECPS Executive Committee, the peer reviews of those

firms will include "agreed upon procedures" in the two years between the firm's triennial reviews.

- A new membership requirement of the SECPS relating to self-disciplinary procedures in the event of litigation alleging deficiencies in the conduct of an audit of financial statements of a public company that files reports with the SEC. These procedures call for the firms, in certain situations, to terminate, remove from audits of public companies, or subject to additional oversight the individual involved. In connection with this new SECPS membership requirement, the Quality Control Inquiry Committee, which also is subject to POB oversight, has revised its operating procedures.

The POB looks forward to its expanded role designed to serve the public interest through its oversight activities with respect to improving the quality of independent audits of financial statements of public companies. The POB will focus

on the oversight reviews of independence and monitor the implementation of the Panel's recommendations contained in its report. We plan to report on the progress of these matters in our next Annual Report. We also intend to encourage and work toward an improved relationship between the accounting profession and the SEC in the years ahead. Voluntary cooperative self-regulation in the accounting profession is in the public interest. As the Panel noted, "a revitalized relation-

ship [between the SEC and the accounting profession] can facilitate progress in improving audit effectiveness and can enable the participants to work in harmony for the public interest."

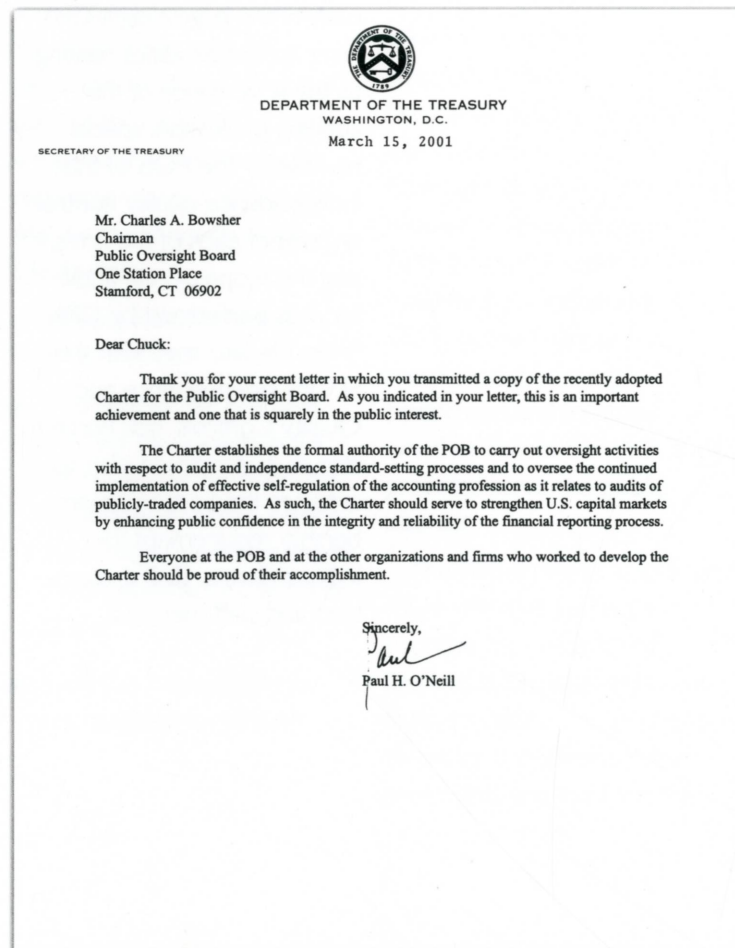
In closing, we wish to thank The Honorable Robert Froehlke, former Chairman of Equitable Life Assurance Company and Secretary of the Army, who recently retired from the POB. He rendered devoted and outstanding service for many years in

promoting the public interest. And, we extend our best wishes to Paul O'Neill who recently resigned from the POB to become Secretary of the Treasury in the new Administration. At the same time, we welcome our newest members of the POB, Mr. Norman Augustine, former Chairman and CEO of Lockheed Martin Corp., and Ms. Aulana Peters, a former SEC Commissioner. We look forward to working with them in the coming years.

Respectfully submitted,

Charles A. Bowsher

Charles A. Bowsher
Chairman
Public Oversight Board



The John J. McCloy Award

The POB selected Shaun F. O'Malley as the recipient of the 2000 John J. McCloy Award for outstanding contributions to the auditing profession in the U.S.

From 1988 until his retirement in 1995, Mr. O'Malley served as the Chairman, Chief Executive Officer, and Senior Partner of Price Waterhouse LLP. Throughout his career, Mr. O'Malley has been committed to improving audit effectiveness, the quality of accounting standards and practice, and the governance of the profession. Most recently, he chaired the POB's Panel on Audit Effectiveness. His statesmanship was crucial in leading the Panel during its nearly two years of intensive study, research, interviews, public hearings, and preparation of a report that will set the profession's agenda for years. His efforts to improve accounting standards and practice are evidenced by his membership on and chairmanship of the Board of Trustees of the Financial Accounting Foundation.

POB Activities

The Board held nine regularly scheduled meetings and three special meetings during the year ended December 31, 2000. At those meetings, the Board discussed the governance of the auditing profession – including the POB's role, and matters relating to auditor independence and the effectiveness of audits – with the chairman and staff director of the Panel on Audit Effectiveness, the Chairman of the SEC, the Chairman of the SECPS Executive Committee and the SECPS Staff Director, and the leadership of the AICPA.

The Board's chairman met with the chief executive of each of the largest eight CPA firms to discuss issues relating to the governance of the auditing profession, special reviews by the POB of the independence quality control systems of each of the firms, and the scope of non-audit services performed by CPA firms. He also met with the SECPS Independence and Quality Controls Task Force to discuss its proposed plan to enhance the Section's membership requirement for independence. Board members and staff met on a

number of occasions with the Chairman, Chief Accountant and General Counsel of the SEC.

Board members and staff participated in the deliberations of the SECPS task forces on Peer Review Standards, the Quality Control Inquiry Process, Independence and Quality Controls, International Issues, the Disciplinary Process, and Associations of CPA Firms. The staff also participated in a meeting of the Transnational Audit Committee's Quality Assurance Sub-Committee that, under the auspices of the International Federation of Accountants and with the assistance of several firms involved in auditing transnational clients, is working to establish a global peer review program.

The Board also held an "outreach meeting" with representatives of firms practicing in Arizona, the Arizona State Board of Accountancy, and the Arizona State Society of CPAs. Topics discussed included, among others, issues relating to the independence and objectivity of auditors and the recommendations of the Panel on Audit Effectiveness.

Governance of the Auditing Profession

An important milestone in the history of the self-regulatory system of the accounting profession was reached on February 9, 2001 when the Public Oversight Board announced agreement on a Charter aimed at strengthening and broadening its oversight of the profession. The Charter was approved after extensive discussions with the AICPA, the SEC Practice Section, the large auditing firms, and the SEC. The Charter represents an important milestone in the history of the self-regulatory system of the accounting profession. The POB had been operating pursuant to By-laws and organizational documents, but no charter, since its formation in 1977. The provisions of the new POB Charter are generally consistent with recommendations issued last year by the Panel on Audit Effectiveness.

Principal features of the Charter include:

- Oversight for the first time over key participants in the self-regulatory process of the accounting profession, namely, the Auditing Standards Board and Independence Standards Board.
- Expanded responsibility for improving communication

among the various bodies that make up the self-regulatory system by creating a new coordinating task force.

- Expanded responsibilities to conduct oversight reviews and to undertake other projects and actions that are deemed to be appropriate to protect the public interest.
- Increased resources, both in staffing and budget.

The full text of the Charter is available on the Board's web site, www.publicoversightboard.org.

Panel on Audit Effectiveness

On September 6, 2000, the Panel on Audit Effectiveness released its *Report and Recommendations*. The Panel was appointed by the Public Oversight Board in 1998 at the request of SEC Chairman Arthur Levitt to review and evaluate how independent audits of the financial statements of public companies are performed and to assess whether recent trends in audit practices serve the public interest.

The Report's goal is to foster more effective audits that improve the reliability of financial statements, enhance their credibility, contribute to investors' confidence in the profession, and improve the

efficiency of the capital markets. The Report indicates that while the quality of audits is fundamentally sound, both how they are conducted and the governance of the auditing profession need improvement.

The Panel's recommendations include:

- Auditors should perform some "forensic-type" procedures on every audit to enhance the prospects of detecting material financial statement fraud.
- The Auditing Standards Board should make auditing and quality control standards more specific and definitive in certain specified areas and audit firms should review (and where appropriate) enhance their audit methodologies, guidance, and training materials; and peer reviewers should "close the loop" by reviewing those materials and their implementation on audit engagements and then reporting their findings.
- Audit firms should put more emphasis on the performance of high quality audits in communications from top management, performance evaluations, training, and compensation and promotion decisions.
- The POB, the AICPA, the SECPS, and the SEC should agree on a unified system of

governance under a strengthened POB that would oversee standard setting (for auditing, independence, and quality control), monitoring, discipline, and special reviews.

- A majority of the members of the Independence Standards Board (ISB) should be from outside the profession, and the SEC should encourage and support the ISB in carrying out its mission.
- The SECPS should strengthen the peer review process, including performing some portion of the peer review of the largest firms each year, and the POB should expand its oversight of those reviews.
- The SECPS should strengthen certain aspects of its disciplinary process.
- Audit committees should pre-approve non-audit services that exceed a threshold amount and should consider certain specified factors when doing so. The ISB should identify the factors.
- The International Federation of Accountants should establish an international self-regulatory system for the international auditing profession.

The POB gave the Panel a broad mandate to review and evaluate the way independent audits are performed and the effects of recent trends in auditing on the public interest. The Board believes that the Panel has completed the most thorough examination of the audit process undertaken in the history of the accounting profession. The Board will monitor implementation of the Panel's recommendations and will report the status of progress in its future annual reports.

The Report is available on the Panel's web site, www.pobauditpanel.org.

Auditor Independence

Updating the Independence Rules

In a speech on May 10, 2000, the then Chairman of the SEC committed the Commission "to work with the profession and the Independence Standards Board to undertake in short order a long overdue modernization of certain financial investment rules." He informed those interested in auditor independence that the SEC staff would submit a proposal to the Commission by the summer, indicating that he was directing the staff to "prepare a rulemaking initiative on how best to deal with the conflicts created by the

profession's ever-expanding menu of services offered to public company audit clients." On June 30, 2000, the Commission issued a comprehensive proposal to revise its auditor independence rules.

After holding four days of public hearings involving almost 100 individuals and receiving almost 3,000 letters of comments, the SEC issued its final rules on auditor independence on November 21, 2000. Most of them took effect by February 5, 2001 (with transition rules beyond that date for a few of the rules). The final rules differed in several respects from the original proposal.

The new rules identify nine non-audit services that if provided to an audit client, could, depending upon the circumstances, raise issues with respect to an auditor's independence. While these rules in many respects are consistent with existing requirements, they also contain additional restrictions in certain areas such as internal audit, information technology, appraisal and valuation services. The rules also require annual proxy statement disclosure of the fees for audit, information

technology and other non-audit services provided by the auditors, whether the audit committee considered the compatibility of non-audit services with the auditor's independence, and disclosure of leased personnel in connection with the audit. In addition, the rules significantly reduce the number of audit firm employees and their family members whose investments in audit clients would impair independence. They also narrow significantly the circle of family members and former firm personnel whose employment with an audit client would impair independence.

The rules provide audit firms with a limited exception (a "safe harbor") from being deemed not independent because of certain inadvertent actions by their partners and employees if a firm has in place a quality control system that provides reasonable assurance of compliance with the independence rules. (In addition, the partner or employee must not have known that independence was impaired and the violation must have been corrected as soon as it was identified.) The Commission noted that foreign offices, or foreign "associated" or "sister" firms of domestic

firms, may require additional time to develop and implement the necessary standards for "large firm" quality control systems. Consequently, the Commission has given the firms' foreign offices until December 31, 2002 to implement those standards. Even before that date, however, the firm's system of quality control must provide "reasonable assurance" of compliance with the independence rules by all employees and associated entities of the firm participating in the audit of a U.S. registrant, including employees and associated entities located outside the U.S.

Independence Standards Board

The POB's new Charter for the first time gives the POB oversight authority of the Independence Standards Board (ISB). The ISB's purpose is "to permit timely, thorough, and open study of issues involving auditor independence and to encourage broad public participation in the process of establishing and improving independence standards." In view of the history of the ISB and the new comprehensive SEC rules on independence requirements, there is consideration being given and

discussions among the ISB, the major accounting firms, the AICPA, and the SEC as to the existence or future role of the ISB. The POB is being consulted on this matter and will monitor developments in its new oversight role.

Look-Back and Special Reviews of Large Firms

As our 1999 Annual Report noted, the SEC settled charges against PricewaterhouseCoopers LLP (PwC) for engaging in improper professional conduct by violating SEC auditor independence rules. As part of that settlement, that firm agreed to conduct an internal investigation supervised by a SEC-appointed independent consultant which disclosed a substantial number of instances of non-compliance with the independence rules. In January 2000, prompted by this disclosure, the SEC questioned whether similar non-compliance also might be found in the other large firms if they were subjected to a review of their compliance with independence rules.

Negotiations during the first half of 2000 between the SEC staff and the Big Five accounting firms led to what became known as the "voluntary look-back program." The program, in which all of the eight largest firms agreed to participate, focuses on evaluating compliance with independence requirements. This program includes a safe harbor from enforcement actions regarding all but the most serious independence violations, such as when a firm itself or senior persons working on an audit own stock in an audit client. As part of the voluntary look-back program, and as outlined in a letter to the POB from the SEC's chief accountant in September 2000, the POB is to undertake the following oversight of the participating firms' systems, procedures, and internal controls relating to independence:

- "Firms would submit to review and oversight by the POB of the effectiveness of the design and implementation of these systems, procedures, and internal controls, and to testing by the peer reviewers or the POB of their effectiveness."

- "If the testing is performed by a peer reviewer, the POB shall have oversight of the peer review. Firms would agree to cooperate with the POB in such review and oversight."
- The POB would issue "two separate public written reports with respect to: (i) the effectiveness of the design and implementation of these systems, procedures, and internal controls as of January 1, 2001 and (ii) the testing and evaluation of their operating effectiveness during the six-month period ending June 30, 2001. Such reports will not disclose violations."

The Board and its staff are committed to conducting this important oversight project. The Board's staff and outside counsel to the Board are currently working with the SEC and the firms, through the SECPS, to develop a work plan and a timetable for the project.

SECPS Executive Committee

The Executive Committee is responsible for all the self-regulatory activities of the SEC Practice Section and for setting membership requirements for member firms. Membership requirements, such as the newly established self-disciplinary requirement, are intended to enhance the quality of audit practice and bolster the confidence of users of financial reports in the effectiveness of self-regulation.

A Board member and staff actively participate in each meeting of the SECPS Executive Committee and its Planning Committee. As discussed below, in 2000 the Executive Committee substantially enhanced its independence membership requirement for member firms that were passed in 1999. In addition, the Executive Committee established a new self-disciplinary requirement that is intended to provide greater protection to the public.

The Executive Committee's Professional Issues Task Force (PITF) issued four Practice Alerts: *Accounting for Certain Equity Transactions*, *Quality of Accounting Principles-Guidance for Discussion with Audit Committees*, *Auditing Construction Contracts*, and *Quarterly Review Procedures for Public Companies*. (These are available on the AICPA web site or

in the AICPA Technical Practice Aids.) The Board's staff participates in the accumulation and consideration of practice issues at PITF meetings.

Revised Independence Requirements

As we reported in our 1999 Report, in October 1999 the Executive Committee adopted a new membership requirement concerning the quality control systems of member firms in the area of independence. This requirement became effective during the year 2000.

The Chief Accountant of the SEC continued to express concern about the adequacy of the independence quality controls of public accounting firms. In December 1999, in a letter to the Chairman of the Executive Committee, he described "the basic requirements for a comprehensive system of independence quality controls," and informed him that revised independence membership requirements should be adopted by March 31, 2000 and implemented no later than January 1, 2001.

On March 24, 2000, following the recommendation of its Task Force on Independence and Quality Controls, the Executive Committee unanimously voted to further revise the independence membership requirement. The additional requirements are described in Table I along with those adopted in 1999. Both

the 1999 and 2000 requirements became effective at various times in 2000, with all elements being effective no later than December 31, 2000.

New Self-Disciplinary Requirement

Over the years, there has been criticism about the effectiveness of the profession's disciplinary system. The Panel concluded that the profession's current disciplinary process could be improved to provide greater protection to the public. In response to the Panel recommendations, the SECPS Executive Committee adopted a new self-disciplinary membership requirement. This requirement provides that SECPS member firms have quality control policies and procedures in place, so that, in the event of litigation alleging deficiencies in the conduct of an audit of financial statements of a present or former SEC client, the firms will report that matter to the Quality Control Inquiry Committee (QCIC) and follow other applicable procedures of the QCIC. These procedures call for the member firm to conduct a review of the engagement that is the subject of the litigation in order to evaluate certain senior engagement personnel. The QCIC will review this matter and, if appropriate, will refer it to the AICPA Professional Ethics Division (Division). The Division will assess whether or not the matter warrants investigation. If the Division

determines an investigation is appropriate, it will inform the member firm of that and also that the investigation of the matter will be deferred until the litigation is resolved. Once the member firm and the audit engagement partner involved have been notified by the Division that the matter is being deferred, then the firm must select one of the following options to apply to the engagement partner during the period of deferral, if that individual is still associated with the firm:

- Terminate or retire the individual.
- Remove the individual from performing or supervising audits of public companies until the Division's process is completed.
- Subject the individual to additional, prescribed oversight on all public company audit engagements in which she/he is involved for at least one year.

Implementation of the option chosen is subject to review through the peer review

process and by the POB. If the individual leaves the firm and joins another SECPS firm, the successor firm must select one of the three options.

The POB believes the SECPS membership requirements concerning disciplinary procedures made in response to the Panel's recommendations, together with the related QCIC involvement, will further the public interest.

A New Approach to Peer Review

Based on recommendations made by the SECPS as a result of a re-evaluation of its peer

review program and of the Panel on Audit Effectiveness, in January 2001 the Executive Committee approved the pilot test of a plan to significantly modify the approach to conducting and reporting on peer reviews, including, for the largest firms, requiring "continuous" peer reviews.

More In-depth Reviews

Over the past year, the Peer Review Committee, through its various subgroups of volunteers and under the active oversight of the POB and the SEC staff, completed guidance on an approach to peer reviews that will be pilot tested in 2001 for the largest firms and a sample of other member firms. Peer reviews under that approach will use some review techniques on a sample of engagements reviewed that are similar to the techniques used by the Panel on Audit Effectiveness in the summer of 1999. The objectives of this approach are to obtain an in-depth understanding of the engagement team's approach to the audit and thought processes, as well as insight into the knowledge, skills, training and experience of the engagement team, and to develop:

- Observations regarding the quality of the engagement team's performance in certain

Table 1 – 1999/2000 INDEPENDENCE REQUIREMENTS

- Establish independence policies and make them available to all U.S. professionals and to partners and managers in foreign-associated firms.
- Require independence training of each professional performing professional services for clients.
- Maintain a database of restricted entities and require review of the database by all U.S. professionals before acquiring a security, obtaining a loan or opening or modifying a brokerage account.
- Obtain confirmation from each U.S. professional of compliance near the time of employment and annually thereafter. Each professional is required to report apparent violations and the related corrective action taken or to be taken.
- Follow-up to determine that adequate corrective action has been taken and documented on all apparent reported violations.
- For firms with 7500 or more professionals, implement an electronic tracking system and automated restricted entity list by December 31, 2000.
- Implement a monitoring system that includes procedures to test compliance by U.S. partners and managers with the restricted entity list. For example, on a sample basis, the information submitted by partners and managers would be audited by comparison to brokerage statements and other relevant documents.
- Develop as part of the firm's independence policies, guidelines for actions to be taken against U.S. professionals for their violations of the member firm's independence policies.
- Designate a senior-level partner responsible for overseeing the independence quality control system.

areas reviewed, including both best practices and areas for improvement.

- Observations regarding the engagement team's application of the firm's policies, guidance, procedures and practice aids, including best practices and areas for improvement.
- Recommendations that would improve the firm's policies, guidance, procedures, practice aids or training programs and/or professional standards.

The Peer Review Committee also expects these more in-depth reviews of aspects of engagements and interviews of audit engagement personnel to provide information to the Peer Review Committee on how firms are addressing emerging issues and higher-risk areas in audits, and to provide input for the Peer Review Committee to prepare an annual report that will, among other things, contain matters for consideration by standard setting bodies, regulators and other interested parties.

Continuous Peer Reviews

The implementation of "continuous" peer reviews for large firms will be pilot tested in 2001. In each of the first two years of a large firm's three-year peer review cycle, peer reviewers will perform "agreed-upon procedures" that have been developed by the Peer Review Committee. These procedures will focus on the firm's monitoring proce-

dures and require the peer reviewers to interview appropriate personnel and obtain other evidence to gain an understanding of whether during the year the firm considered and evaluated:

- The relevance and adequacy of its policies and procedures.
- The appropriateness of its guidance materials and practice aids.
- The effectiveness of its professional development activities.
- Compliance with its policies and procedures.

In addition, the peer reviewers will evaluate the comprehensiveness of the firm's inspection program by reviewing the plan for the year, including the questionnaires to be used, the summarization of findings, and the corrective action plan required by the findings. Some of the engagements selected for inspection in the continuous peer review pilot program also will employ the more in-depth review approach described above.

An "agreed upon procedures" report will be issued to the firm and the Peer Review Committee. The report would be available to the POB and the SEC, but would not be included in the Section's public file. The report will identify any significant quality control deficiencies not found by the firm's monitoring program and on any failures to

take adequate or timely corrective actions to cure deficiencies identified in the previous peer review or inspection.

On completion of the pilot test, the Peer Review Committee will assess its effectiveness and develop revised peer review standards. The Executive Committee supported the Peer Review Committee in this endeavor. The Peer Review Committee members have devoted much time and effort to advancing this important project that furthers the public interest.

Reporting Streamlined

The Peer Review Committee has completed its project to streamline reporting on peer reviews. Under the revised reporting approach, there will continue to be a peer review report and a letter of comments written by the reviewer to which the firm is expected to respond. The report and letter will no longer be addressed only to the firm, however, but also to the Peer Review Committee. In the case of a modified report, readers will no longer have to refer to the letter of comments to understand fully the reasons for the modifications. Both the reasons and the recommendations to cure deficiencies will be in the report itself. Other comments that are not of sufficient significance to lead to a modified report, however, and related recommendations will

be in the letter of comments. The reviewed firm's response will address both sets of recommendations. In the case of an adverse report, all of the deficiencies identified are now required to be included in the peer review report.

To help users of the public file understand the peer review process, each report also will be accompanied by an attachment describing the entire process, including the roles of the Peer Review Committee, the POB, the public file, and how peer reviews are planned and performed.

The Board believes that these revisions should help users of the public file better understand both the peer review findings and the entire peer review process.

Sanctions

In the event member firms fail to cooperate with the SECPS and its committees, sanctions against the member firms can be imposed. In 2000 one member firm failed to cooperate with the inquiry process of the QCIC and the Executive Committee formed a hearing panel to consider sanctions. On November 28, 2000, the panel unanimously voted to expel the firm from membership in the SECPS. This is the first occurrence, since the QCIC's inception in 1979, that a firm failed to cooperate with the QCIC.

Peer Review Process

Virtually all U.S. accounting firms that audit publicly held companies belong to the SEC Practice Section and are required to abide by its membership requirements. Since 1977, when the profession's self regulatory process began, triennial peer review of member firms' accounting and auditing practices has been the most visible of the Section's membership requirements. The purpose of peer review is to provide assurance to the public and the reviewed firm that an effective quality control system has been established that provides reasonable assurance of complying with professional standards. The SECPS Peer Review Committee sets the standards for conducting peer reviews and oversees the administration of the peer review program.

POB Oversight of the Peer Review Process

Approximately 1,300 U.S. accounting firms belong to the SECPS and undergo triennial peer reviews. During the 1999-2000 peer review year, 441

SECPS peer reviews were performed, including 261 reviews of firms that audit SEC registrants and 180 reviews of firms that had no SEC clients.

For all firms that audit SEC registrants, the Board's staff performs some level of oversight. The degree of oversight varies based on the profiles of the firm and the peer reviewer. For example, firms with large numbers of public clients, firms with a history of performance problems (including litigation and regulatory enforcement actions), and firms undergoing their initial peer review receive a more intensive level of oversight. Similarly, peer reviewers who have had past performance problems receive added attention. The Board's staff applies one of three levels of oversight to every peer review: visitation and working paper review, working paper review only, and selective working paper review.

Oversight of Large Firm Peer Reviews

During the 1999-2000 year, the Board's staff conducted comprehensive oversight of the peer reviews of three of the largest five firms. The staff's oversight of these reviews, which occurred from May to November, covered planning, reviewing offices and engagements, summarizing findings, developing the report and letter of comments, and finally communicating the findings to firm management at the final exit conference.

One of the three firms, PricewaterhouseCoopers LLP (PwC) underwent a peer review solely of the design of its quality control system during the 1999-2000 year (the newly designed system had not been fully implemented at that time). The Peer Review Committee, in consultation with the Board, had concluded that it would be in the public interest to have timely assurance that the firm, which resulted from the July 1, 1998 merger of Price Waterhouse LLP and Coopers & Lybrand LLP, had designed an appropriate system and trained the personnel of the two legacy firms in its intricacies. A major feature of the new system that was tested as part of the peer review was the design of an independence system, which included an investment tracking system for, and procedures for auditing the representations of, investments of partners and managers.

The peer reviewing firm issued an unqualified opinion on the design of PwC's system as of September 30, 1999. The report included a paragraph explaining the impact on PwC's independence system of its agreement to the entry of the SEC Consent Order.

PwC also underwent a peer review during the 2000-2001 peer review year that tested implementation and compliance with new quality control systems including that related to independence. The firm

received an unmodified opinion with a letter of comments.

The other two of the largest five firms underwent peer reviews of both the design of and compliance with their quality control policies during the 1999-2000 year. Those firms received unqualified opinions on their peer reviews. For each firm, a letter of comments accompanied the peer review report.

During their oversight of large firms peer reviewed in 1999-2000, the SEC staff had access to the peer review working papers, related POB oversight files, the team captains who conducted the reviews, and POB oversight staff. With the agreement of the SECPS Executive Committee, and to enhance the SEC staff's understanding of the peer review process, the firms voluntarily provided the SEC staff with a level of access beyond that specified in a "Memorandum of Understanding" that had been agreed to by the SEC, the SECPS, and the POB in 1982.

The SEC raised two issues as a result of their oversight. First, the SEC believes that "if the peer review process is going to remain effective, it must include adequate, transparent public disclosure of all significant issues identified." The

SEC also suggested that timely follow-up on the corrective actions taken to deal with the matters in the letter of comments would improve the effectiveness of the peer review process.

The Board has brought the SEC's comment about the transparency of comments in letters of comments to the attention of the Executive Committee and the Peer Review Committee. The Peer Review Committee, as part of its review of the peer review standards in 2000, considered the adequacy of its guidance for writing letters of comments and concluded that the guidance is adequate but notwithstanding, the Peer Review Committee and the POB intend to monitor interpretation of the guidance to assess whether future letters of comments are responsive to the issues raised by the SEC. The implementation of the "continuous" peer reviews for the largest firms that will be pilot tested in 2001 will address the timely follow-up on corrective actions taken to deal with matters in the letter of comments.

Oversight of Other Firm Peer Reviews

During the 1999-2000 peer review year, the Board's staff directly participated, through on-site visits, in the reviews of 55 firms with SEC clients.

During these visitations, the staff reviewed the peer review working papers, evaluated the qualifications of the reviewers, reviewed the scope and findings with the review team, and participated in the final exit conference with representatives of the reviewed firm. The staff also often reviewed client financial statements and supporting working papers to obtain a better understanding of the review findings and to test the comprehensiveness of the reviewer's work. Sixteen of the firms visited had more than five SEC clients, seven received modified or adverse reports on their previous peer reviews, and seven were undergoing their initial review. The Board's staff visited and participated in the reviews of 47% of the firms with more than five SEC clients, 58% of the firms with SEC clients that received modified reports on their quality control systems during their previous peer review, and 36% of the firms undergoing their initial peer review.

In addition to the on-site visits, the Board's staff reviewed the peer review reports and all reviewers' working papers for reviews of 114 firms. During this oversight process, the Board's staff discussed significant issues and findings with the review team, determined whether the

reviewers' had the industry and regulatory qualifications to perform the review, and obtained explanations and clarifications of matters regarding the scope of review, the significance of systemic and engagement findings, and the consistency of findings in the peer review reports. The Board's staff satisfied itself that all significant matters were properly addressed and resolved and reported on in accordance with the peer review standards.

For the 272 firms (of which 92 have SEC clients) not subject to the more intensive visitation and working paper review oversight programs, the staff performed a more limited review of the peer review reports and selected reviewer working papers. In those instances, the SECPS staff performed either an on-site visit or a detailed review of the peer review reports and working papers. The SECPS staff performed a more limited review of the peer review reports and selected reviewer working papers for the balance of the 1999-2000 peer reviews.

After the peer reviews are reviewed by either the Board's staff or SECPS staff, the reports are presented to the Evaluations Task Force (ETF) of the SECPS Peer Review Committee. The ETF meets once or twice a month to

consider and accept the individual peer reviews reports. Because of the higher level of public interest in firms with a large number of SEC clients, reports on firms with 30 or more SEC clients are considered and accepted by the entire Peer Review Committee. During the consideration of each peer review, the Board and SECPS staffs participate in the discussions and communicates significant matters that arose in the course of their oversight. Once the ETF or the Peer Review Committee accepts the reports, they are placed in files at the AICPA that are available to the public.

The Peer Review Committee met four times in 2000. A Board member and/or the staff participated in each of those meetings. The ETF met 18 times; the Board's staff participated in each of those meetings.

The Peer Review Committee's Consideration of Peer Review Reports

As of January 1, 2001, the SECPS Peer Review Committee and its ETF had considered and processed 439 of the 1999 peer reviews. Two reviews had not been processed. In one case, the reviewed firm, which had received an adverse opinion on its previous review, refused to permit the reviewers to complete the peer review. The firm has submitted its resignation from the Section, and the practitioner

has resigned from the AICPA. Those resignations became effective January 2001. The adverse report from the firm's previous peer review will remain in the public file for a period not to exceed three years. A memorandum has been added to the public file indicating the circumstances of that peer review. In the other case, POB and SECPS staff questioned issues concerning the nature of the firm's practice and the scope of the peer review. Those matters have recently been resolved and the peer review was subsequently accepted.

Since 1981, the Section and the Board has had a formal "Memorandum of Understanding" with the SEC's Office of the Chief Accountant to provide it with access to the peer review process and Board's staff oversight procedures. The purpose of SEC oversight, as described in the Memorandum, is to enable the SEC staff to make its own independent evaluation of the peer review standards, the effectiveness of the application of those standards in assuring the quality of audits performed by those who practice before the SEC, and the effectiveness of POB monitoring and oversight of the peer review program. For the 1999-2000 peer review year, the SEC staff visited the Board's offices and reviewed the peer review reports, peer review working papers, and Board oversight files on the reviews of 19 firms.

In addition, the SEC staff reviewed the Board's oversight files on the reviews of an additional 42 firms.

The Peer Review Committee's Imposition and Monitoring of Corrective Actions

As part of its processing of peer review reports, the Peer Review Committee and its ETF consider whether the findings warrant additional follow up by the Committee to assure that the public interest is properly protected and the firm is taking the appropriate corrective actions to address its peer review findings.

When the Peer Review Committee concludes that the corrective actions proposed by the reviewed firm are not adequate or that similar deficiencies have occurred on successive peer reviews, the Peer Review Committee may request the reviewed firm to implement specific corrective actions beyond those recommended by the peer reviewer. In addition, if the design or compliance deficiencies are particularly severe, the Peer Review Committee may ask the firm to demonstrate corrective actions to the satisfaction of the review team captain. The firms reviewed in the 1999-2000 peer review year, subject to such actions, have agreed to accept all

remedial corrective actions requested by the Committee. Table II summarizes Committee-imposed corrective actions.

Association Administered Peer Reviews

The Joint Task Force on Associations, comprised of representatives from the Peer Review Committee and the AICPA Peer Review Board, was formed to consider issues involving peer reviews conducted through CPA associations. Associations of CPA firms have been formed over the years to assist their member firms in developing quality control materials, to conduct continuing education and firm management seminars, and to provide referral and consultation services. In recent years, both formal associations and groups of firms have collaborated on various forms of business relationships, including investments in entities that deliver non-audit services, programs for marketing services, alliances of various types, networks, and other collaborative efforts.

The Joint Task Force has focused its attention on the extent to which these relationships and collaborative efforts may adversely affect or be perceived to adversely affect a firm's independence and objectivity when it conducts a peer review of an associated firm. The Board's staff is participating in the task force's

deliberations. The recommendations of the task force are expected to be considered by the Peer Review Committee in 2001.

Summary and Conclusions

The Board believes that the peer review process continues to contribute to improvements in the quality control systems of member firms and to the quality of auditing performed in the United States. The report of the Panel on Audit Effectiveness contains many recommendations that, if

adopted, should result in more effective peer reviews. The Board also appreciates the constructive suggestions of the SEC staff to improve both the quality of auditing and the effectiveness of peer reviews. The Board is monitoring the efforts to evaluate and implement recommendations and suggestions that will improve the effectiveness of audits and thereby contribute to enhancing investors' confidence in the profession.

Table 2 - Major Corrective Measures Imposed by the Peer Review Committee to Ensure that Quality Control Deficiencies are Corrected

Action	Number of Times	
	12 Months Ended 6/30/00	Since Inception 1978
Accelerated peer review	0	54
Employment of an outside consultant to perform preissuance reviews of financial statements or other specified procedures	8	118
Oversight by the peer reviewers or by a Peer Review Committee member to monitor progress made by the firm in implementing corrective actions	14	234
Oversight of the firm's internal monitoring program	36	438
Changes made in the firm's quality control document or other guidance materials	0	44
Continuing professional education in specified areas	9	71 *

* Since July 1, 1988, as data for prior years is no longer available

Quality Control Inquiry Process

The Quality Control Inquiry Committee (QCIC) is a critical part of the accounting profession's self-regulatory program and a vital complement to the peer review process. Member firms are required to report to the QCIC, within thirty days of service, all litigation alleging deficiencies in the conduct of an audit of the financial statements of a SEC registrant and certain other entities. The QCIC's primary focus is on ascertaining if the allegations in the complaints indicate a need for the respondents to take specific corrective actions to improve their quality control systems or if there are profession-wide issues that need to be addressed.

POB Oversight of the SECPS Quality Control Inquiry Process

The Board and its staff have unrestricted access to the QCIC process and actively participate in the discussion of the implications of the allegations in each case that takes place between the assigned QCIC task force and the member firm. They attended all QCIC meetings and observed the consideration given by the QCIC to each case. For all cases considered by the QCIC, the staff reads the complaints submitted by member firms, SEC Accounting and Auditing Enforcement Releases against company

personnel and accountants, relevant financial statements and regulatory filings, and other publicly available documents.

The Board's staff participated in all 52 QCIC task force meetings with member firms during the year. The POB staff prepares a comprehensive report on each specific case meeting for discussion with the Board.

QCIC Activity

The QCIC began the year with 40 cases on its agenda, 58 new cases were opened during the year and 47 cases were closed. At June 30, 2000 there were 51 open cases.

As part of its initial analysis of each case reported by a member firm, the QCIC reviews the complaints, applicable financial statements and regulatory filings, and other relevant public documents. After its initial analysis, the QCIC determined that there were no quality control or personnel issues to pursue on 3 cases and closed them.

For the 44 cases that were closed at a stage after initial analysis, the QCIC task forces met with firm representatives to gain an understanding of the work performed in the areas of alleged audit failure and the potential implications for the firm's quality control policies and procedures. Where necessary, the QCIC task forces reviewed firm guidance materials and, on occasion, selected engagement working papers relevant to particular allegations.

Revisions to QCIC Operating Procedures

During the year, with the participation of the POB staff and input from the SECPS member firms, the QCIC reconsidered its operating procedures and analyzed Section 7000 of the SEC Practice Section Reference Manual – Objectives, Organization, and Operations of the Quality Control Inquiry Committee. The QCIC concluded that extensive revisions were necessary to describe appropriately its current activities, reduce the timeline for processing cases, and focus additional attention on the actions firms take to protect the public from potentially substandard performance of senior personnel involved in alleged audit failures. In addition, descriptions of the QCIC's procedures that were inconsistent with existing practices were eliminated. The SECPS Executive Committee approved the QCIC recommendations.

The most significant change in the QCIC's operating procedures was made to implement the new self-disciplinary membership requirement approved by the Executive Committee in response to concerns raised by the POB's Panel on Audit Effectiveness that the profession's disciplinary system was not sufficiently protecting the public from substandard performance. In connection with the membership require-

ment, the QCIC has revised its procedures to provide that it will not close any case where it has a concern about the performance of senior personnel until it is satisfied that the member firm had reviewed other public company audits that senior audit personnel associated with the case were responsible for within the preceding twelve months.

Reducing the Time to Process Cases

The QCIC has established a timetable for processing cases to accelerate their resolution and the implementation of corrective actions by firms, when necessary. The QCIC also has enlisted firms' coop-

eration in further reducing the time to close QCIC cases. In addition, the SECPS Executive Committee has approved hiring additional staff to improve the timeliness of QCIC activity.

Involving Specialists in the Inquiry Process

The Panel on Audit Effectiveness recommended that the QCIC establish a panel of industry specialists and experts who would be available to QCIC members and the POB

and the SECPS staffs for consultation on various matters, such as: industry issues and application of accounting standards. The QCIC has adopted the substance of the recommendation and will avail itself of industry specialists and experts when appropriate.

Communications with Standard Setters and the PITF

During its consideration of cases, the QCIC may determine that there are areas of practice where additional

standards or guidance would be beneficial. These matters are generally referred to the SECPS Professional Issues Task Force (PITF), which either develops "best practices" guidance for profession-wide distribution or refers the matters to standard-setting bodies for their consideration. The QCIC also may refer certain issues directly to a standard setting body.

The QCIC referred three issues to the PITF during the year. One issue appeared in

Table **3** - QCIC ACTIVITY

	Inception 11/1/79 through 6/30/99	12 Months ended 6/30/00	Totals
Actions Related to Firms			
Either a special review was made, the firm's regularly scheduled peer review was expanded, or other relevant work was inspected	72	4	76
A firm took appropriate corrective measures that were responsive to the implications of the specific case	133	2	135
Actions Related to Standards			
Appropriate AICPA technical bodies were asked to consider the need for changes in, or guidance on, professional standards	49	1	50
The Professional Issues Task Force was asked to consider the issuance of a Practice Alert	23	3	26
Actions Related to Individuals			
Cases opened by the AICPA Professional Ethics Division as a result of QCIC's concern about the performance of senior audit personnel	50	19	69
	327	29	356

(Note: Frequently more than one action is taken by the QCIC or by the firm on an individual case.)

several cases, and led the QCIC to conclude that non-monetary transactions should have been more thoroughly scrutinized. This was particularly true for smaller companies that issued stock in exchange for property and services. A second issue addressed a pattern noted in several cases in which firms had difficulty in auditing revenue of companies that used the percentage of completion method. A third issue related to difficulties in identifying instances in highly computerized accounting systems of non-standard journal entries that fraudulently improved a company's revenue or other aspects of its financial statements.

During the year, the QCIC questioned on several occasions the substance of the engagement team's understanding of internal control in critical areas. The QCIC noted

that, without a sufficient understanding of internal control, an engagement team risks not developing an appropriate audit program. Consequently, the QCIC requested the Auditing Standards Board (ASB) to provide additional guidance in this area. The ASB added this issue to its agenda and subsequently issued an exposure draft of a *Proposed Statement on Auditing Standards*.

SEC Access to the QCIC Process

The SECPS staff prepares a comprehensive summary for review by the SEC of each case after it is closed that addresses significant allegations, the results of the QCIC inquiries, the procedures performed, any necessary corrective actions taken by the firm, and the basis for the QCIC's conclusion. Additionally, the SEC reviews the POB's oversight files for each case, which include extensive memoranda documenting POB oversight of and participation in the inquiry

process, other procedures performed by the QCIC task forces, and the QCIC and the POB staff evaluation of the case. The review by the staff of the Office of the Chief Accountant of the SEC is to enable the SEC to make its own evaluation of the adequacy of the Practice Section's QCIC program and the effectiveness of the POB's monitoring of that program.

Referral of Individuals to the Professional Ethics Division

During the year, the QCIC informed the Division of sixteen cases in which it believed there may be engagement personnel issues of significance, and recommended that the Division determine whether or not to open an investigation of certain engagement personnel. After reviewing the cases, the Division opened investigations in thirteen of those cases. In addition, the QCIC made specific recommendations to

the Division that an investigation should be initiated in six cases; the Division opened an investigation for each of those cases.

The QCIC occasionally becomes aware of CPAs employed by companies audited by member firms whose behavior may warrant investigation. During the period, nine CPAs principally employed as Chief Financial Officers and other accounting officers were referred to the Division, of which six were opened.

Summary and Conclusions

The Board believes that the QCIC process is functioning as designed and effectively complements the peer review process. It is effective in identifying improvements in quality control systems of firms and areas where the profession would benefit from additional standards or guidance.



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